Global Financial Stability and Central Bank Cooperation
– Lessons Learned –

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I'm very happy to be here both to celebrate with you CEMLA's anniversary and to speak about Central bank Cooperation (CBC hereafter). Indeed, CEMLA is a prime example of valuable cooperation involving CBs across the region and well beyond. As we say in France, "life begins at 60". So long live CEMLA!

Yet, 60 is also an age of wisdom and we are benefiting from the lessons learned and shared by experts who have gathered for this conference. Among them, Agustin Carstens and Jaime Caruana for instance made contributions on similar topics to the recent Financial Stability Review (FSR) of the Banque de France (BdF), which is another good example of CBC. And I'll refer sometimes to this BdF FSR published in April 2012 to illustrate and support my presentation.

After so many speeches, I run the risk of being redundant. But several key ideas are worth emphasizing as they have been especially relevant in the recent period, in contrast with Jaime who has just covered the last 80 years. Let me start with a brief reminder of the main issues being discussed in this panel:

- **'Financial stability' (FS) concerns the resilience to shocks on infrastructures, institutions and markets; I'll use each of the 3 blocks to illustrate my points;**
- **'Global' considers FS across countries to assess spillovers; but no single institution has such a global FS mandate yet, even though the IMF, together with the Financial Stability Forum (FSB), is evolving towards that role;**
- **'CBs', which have historically cared about FS, are increasingly involved in it, if only for a twofold reason: monetary stability may be a necessary condition for ensuring FS, but hasn't been sufficient to do it; as a result, financial instability has in turn distorted monetary policy transmission channels;**
- **Last, putting one's own house in order is necessary but not sufficient in a globalised world, without referring explicitly to the rich literature about this topic. So 'cooperation' is welcome between and beyond CBs, whether through informal exchanges of views, aiming for a level playing field or, more ambitiously, some formal policy coordination or even harmonisation.**

Indeed, not all CBs are in charge of FS, nor are they in charge of the whole FS realm. Thus, the leading thread of my presentation today is to illustrate:

1/ recently, in which areas CBs and CBC have been doing well, or not, and why;

2/ in the future, what they may do, possibly better, or should avoid doing.

[1] The views expressed hereafter do not necessarily reflect those of the Banque de France

1. Recently, what has worked or what hasn't, and has CBC contributed to that?

As often, some results have been good, others bad, and in many instances the jury is still out so that things may not look clear-cut. Therefore I couldn't resist grouping my illustrations into 3 well-known categories: "the Good, the Bad, and the Fuzzy", starring central bankers as the Good! The Good corresponds to some instances of success that can largely, even if not exclusively, be attributed to CBC. The Bad corresponds to some cases of failure, which often took place in spite of CBC, or due to insufficient cooperation. The Fuzzy corresponds to mixed experiences, at times in areas well beyond CBC and its scope.

1.1. As regards the Good, the most quoted examples in this conference are the bilateral swap agreements between CBs: with the FED in dollars since 2008, and between 6 CBs (BoC, BoE, BoJ, ECB, FED, and SNB) in any of their currencies since 2011. Thus no need to elaborate on them.

Another interesting, although less quoted, example is the proven resilience of infrastructures. This success has been built up over several years thanks to the work of the Committee on Payment and Settlements Systems, which brings together central bankers at the Bank for International Settlements (BIS). Despite extreme conditions, with liquidity dry-ups, high activity volumes, and the default of major participants, payment systems have been particularly resilient because of new liquidity management mechanisms and the increasing role of central counterparties. Thus, on the basis of the lessons learned, the G20 decided that all standardised OTC derivative contracts should be cleared through central counterparties by end-2012.

The reasons for success are easy to spot, even if they are less easy to replicate.

- **As payment systems are the plumbing and liquidity the oiling for monetary policy, CBs have the incentive to act and the expertise to do so. They have set up a long-standing cross-border cooperation based on a well-established framework since the Lamfalussy report in 1990. Last, they have the capacity to deliver and are the only oversight authorities.**
- **To generalise, CBs know and trust each other well: on a long-term basis, they meet regularly and discreetly under the aegis of the BIS to establish a common language, a shared framework, best practices and standards or even similar objectives depending on the domain.**

1.2. Now, the Bad, with cases of failure, often despite CBC or due to insufficient CBC. Over the last years, financial markets have provided examples of severe imperfections or even failures, including in those deemed to be the most liquid, such as the interbank and more recently the sovereign debt markets, notably for the euro area (EA) peripherals, with fragmentation risks for the conduct of monetary policy.

For instance the unsecured part of the money market experienced a liquidity dry-up around the time of the Lehman failure. In the EA, unsecured transactions dropped 50% between early 2007 and 2010. In spite of liquidity provision, the main problem has become the lack of trust among players. To what extent does all this call CBC into question?

- **True, there was a lack of both awareness and peer pressure: early warnings in BIS reports or CGFS discussions prior to 2007 were missed since the prevalent motto was at the time: "so far, so good".**
- **True also, even those who cried wolf (too early to be believed or too late to act?) rarely thought about two things: the basic causes and the channels of the financial crisis. First, beyond the lack of information or understanding about sub-primes, CDOs, conduits, etc., the basics of the crisis were for many quarters the usual suspects: excessive risk-taking as well as insufficient capital and control. Second, unexpected propagation channels led to the freezing of the very heart of the system.**
- **Yet, the market collapse was also driven by a sudden shift in private agents' risk perception (e.g. about the quality of assets underlying CDOs) and a severe increase in uncertainty about who was holding which assets; I'll later address the feedback loop between banking and sovereign risks.**
- **Moreover, these causes were rooted in, and compounded by market practices, such as underwriting standards, inaccuracy of risk measurements, poor management tools, private incentives biased towards procyclical risk taking: compensation policy, the role of ratings, etc.**

So even if CBs have remained trustworthy and cooperated to provide liquidity, the latter was hoarded. Too much faith had been placed in regulation, disclosure and market discipline. Doubts emerged about all counterparties.

1.3. This leads us to the fuzzy part of what has worked or what hasn't, focusing this time on institutions and, hence, especially on regulation and supervision. Admittedly, some may argue that certain features of Basel II, which were prepared among CBs and introduced in anticipation of deadlines, might have contributed to the crisis or, at least, didn't prevent it. Others can answer that Basel II had not really started to be implemented in some places, notably in the USA with a different approach. But even if CBs and supervisors were involved, they were not the only players by far. By contrast, some progress is praiseworthy such a large-scale reform like Basel III.

Yet, problems persist. Beyond the mixed results of stress tests, which were hardly coordinated across the world, problems largely stem from the uneven pace of financial regulation reforms and some of their unintended effects. For instance, in order to achieve a level playing field a synchronised move towards new standards is necessary. Yet the Dodd-Frank Act has been delayed by political or private criticisms and time-consuming preparatory reports. In

addition, not all countries have proposed a legal transposition of Basel III as Europe has done with the CRD 4 draft directive, effective as of 2015.

I have limited time today to deal with unintended effects, such as deleveraging, but here are a few points. Banks had to deleverage, including in Europe, which has affected their branches or subsidiaries in Emerging market economies (EMEs); yet, the outcome has been different across EMEs: for instance, in Asia, funding substitutes have worked better than in Latin America. Thus the outcome doesn't seem to depend only on developments in advanced markets. For sure, further studies would be required, as is the case when assessing sudden stops in capital flows and the spillover of Quantitative Easing on neighbours. More generally, in times of crisis, cooperation may also be needed as regards monetary stability and the impact of monetary policies on exchange rates so as to reduce the fear of currency wars.

2. Looking forward, what could CBs, and hence CBC, do (better) or what should they avoid doing?

The choice may not be easy, as illustrated by the well-known joke where the devil gives a newcomer a choice between two doors to enter hell with the following signs: "damned if you do" and "damned if you don't" … Thus, let me rephrase this choice in a slightly less pessimistic way. CBs may first be praised, but eventually they will be damned if they do too much, whether they cooperate or not, as they cannot become "universal problem solvers". Yet, they'll be damned also if they do too little, or at least they will become scapegoats, if they are viewed as doing so. Taking account of the limited mandate of central banks, it is thus necessary but not easy to find a middle way between these two threats.

2.1. On the one hand, CBs –and hence CBC– cannot become the universal problem solver or weapon. Indeed, CBs are rather the ultimate rampart with a limited, though flexible, artillery. Their focus is the conduct of monetary policy even if recent experience has increased their responsibilities in FS. So, given the persistent financial crisis and the zero lower bound, they have had to resort to unconventional measures and have in parallel adjusted their operational framework. This is true even if there are differences in unconventional policy in the EA and that implemented in the US and the UK: the 3 year VLTRO ("very long-term refinancing operation") of the ECB focuses on restoring the market functioning via banks, while QE ("quantitative easing") aims at affecting directly long-term rates and macro-stability.

Yet, the CBs' medication is no panacea and raises several risks of side-effects. First, the main CBs' balance sheets have ballooned in parallel (catching up over the last years a process which had started in the 1990s for the BoJ). This raises potential concerns about exposure to credit risk. For instance, the FED and the BoE held respectively close to 20% of their domestic public tradable debts. Going beyond supporting sovereign leveraging, CBs have tried to offset private

deleveraging. True, accounting safeguards and haircuts, as applied within the Eurosystem, should prevent substantial losses which could jeopardize their financial autonomy; but the mere risk of losses might be sufficient to imperil their credibility. In addition although there is a lot of potential collateral, the higher the risk, the higher the haircut and the lower the extra room for manoeuvre for the efficiency of monetary policy.

Second, the boundary between monetary and fiscal policy has been blurred, as CBs affect the allocation of resources between debtors and creditors. In particular, outright purchases are often viewed as "quasi fiscal" both on the asset side (due to the risks entailed) and on the liability side (as they help finance sovereigns). This leads me back to the sovereign/bank nexus and further risks.

There are indeed signs of generalised "financial repression", i.e. policies aiming at curbing interest rates and enhancing the domestic bias of financial institutions to hold domestic public debt. As in the past, it is tempting again to limit sovereign spreads and eventually deflate public debt as criticised for instance by C. Reinhart.

This enhances the risk of "fiscal dominance" over CBs, threatening the efficiency of monetary transmission channels and the credibility of the price stability goal. The Lender of Last Resort function of CBs to save illiquid banks should not be confused with the bailing out of insolvent states. And this is true whether in a Monetary Union or not, as inflation expectations and, hence, the level of nominal interest rates should eventually increase everywhere in the event of a risk of fiscal dominance.

Last, a parallel risk is looming that I'll call "financial dominance". In most countries, governments and parliaments are closely involved in organising and managing macro-prudential surveillance or supervision. While monetary stability is well-defined, often quantified and attributed exclusively to CBs, FS is not and involves many players. There are surely good reasons for this, but it compounds risks of interference or dominance. Thus, as a whole, the main risk becomes one of confusion, given the possibility of dilution of objectives and the diversity of stakeholders.

2.2. On the other hand, CBs may be damned also if they do too little, or are viewed as doing so. Therefore, the main question becomes: which middle way can CBs help to promote, not exclusively among them, but also via their dialogue and cooperation with others? Returning to the sovereign/bank nexus, I'll distinguish between the global and EMU levels

At the global level, CBs should interact further with sovereigns and regulators.

- CBs may call for fiscal consolidation to restore the relative risk-free nature of sovereign assets, while accommodating its implementation; admittedly, accommodation may be granted mainly ex ante to facilitate Governments'

efforts (if any), as is the case with the BoE "carrot"; or it may be awarded ex post, like in the case of the ECB "stick" which is perceived as awaiting firm commitments by Governments before loosening its monetary stance. Yet in both cases and even in the USA, CBs have become more vocal about fiscal discipline.

- **In the longer term, CBs should call for a review of the weight of sovereign risk in capital requirements, but with a transition period so as to limit counterproductive effects.**
- **CBs may also go further via their role in a number of regulatory boards (BCBS, FSB, ESRB, etc.) with a view to promoting a degree of coordination between macro-prudential policies, as the latter are implemented in each country and may spillover to neighbours. So-called macro-prudential measures, however, should not turn out to be disguised tools for financial repression and protectionism, a concern voiced by C. Reinhart (BdF FSR page 45).**
- **Moreover CBs may try and limit some unintended consequences of regulation such as with the LCR (Liquidity Capital Ratio). Markets have already integrated the expected introduction of the LCR in the medium term and are self-imposing de facto such standards earlier than planned by regulators. This ratio may interact with monetary policy and calls for further refinements.**

As regards EMU, the previous panel has already presented its specifics. While the solution calls for fiscal, and later, political union, which go well beyond the CBs' realm, let me simply recall here that CBs may help to:

- **Move towards a Banking Union, a resolution system and a deposit guarantee fund;**
- **Organise supervision at the European level, based on the same principles as those of monetary policy: centralisation of decision-making and decentralisation of its implementation;**
- **Last, limit the risk of contagion or bank runs in the euro area through the accurate assessment and cleaning-up of banks' balance sheets.**

I will conclude with a few remarks. CBC may help global FS but cannot be a substitute for cooperation of CBs with governments and regulators and among the latter. In Europe particularly, some choices and quantum leaps are political rather than economic or technical. Thus, between the risk of doing too much and that of being perceived as doing too little, the road for CBs is narrow and bumpy.

This is particularly the case as we all know that the devil is not the one pushing CBs from behind, but the one in front of them … as usual hidden in the details of implementation!